In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 72-1461

REBEKAH HARKNESS, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (Pet. App. 21-66) is reported at 469 F. 2d 310. The orders of the Court of Claims filed on December 1, 1972 (Pet. App. 67-68) and February 2, 1973 (Pet. App. 69-70) are not officially reported.

JURISDICTION

The judgment of the Court of Claims was entered on November 10, 1972, and a motion for amendment of the judgment and opinion was denied on February 2, 1973 (Pet. App. 69-70). The petition for a writ of certiorari was filed on April 27, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTION PRESENTED

Whether Section 662(a)(2) of the Internal Revenue Code of 1954, which provides for the proration of the taxable income of estates and trusts among beneficiaries on the basis of distributions to them, is constitutional.

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

The pertinent provisions of Article 1, Section 2, clause 3; Article 1, Section 9, clause 4; the Fifth Amendment; and the Sixteenth Amendment of the Constitution, and of Sections 102 and 662 of the Internal Revenue Code of 1954, 26 U.S.C. 102 and 662, are set forth at Pet. App. 71-74.

Article 1, Section 8, clause 1 of the Constitution provides in pertinent part as follows:

> The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises * * * but all Duties, Imposts and Excises shall be uniform throughout the United States; * * *

STATEMENT

Petitioner's husband died on August 12, 1954. By his will, he left petitioner one-half of his residuary estate. The remaining half was, after the deduction of any death taxes payable by the estate, bequeathed, in equal shares, to the trustees of four testamentary trusts for the children of petitioner and the decedent. The will provided that such taxes "shall be paid by [the] Executors out of [the] estate as part of the expenses of administration thereof," with the proviso that "no part of such taxes shall be deducted from or payable out of the one-half (1/2) of [the] residuary estate" which the decedent bequeathed to petitioner (Pet. App. 22).

During 1955, and prior to the ultimate distribution of the residuary estate, the executors made distributions to the five beneficiaries thereof totalling $36,004,082.23, of which petitioner received $27,467,768.51. The four trusts received the balance of $8,436,295.75 (in equal shares of approximately $2,134,000). All the distributions were in the form of cash, stocks and bonds. None of the distributions was required to be made prior to the ultimate distribution of the residuary estate (Pet. App. 22). During 1955, the executors also paid the New York estate tax and the federal estate tax totalling $18,931,454.81 (Pet. 4).

In the settled accounts of the executors, the distributions to the beneficiaries were characterized as distributions of estate principal or estate income as follows (Pet. App. 62):

Beneficiary	Income	Principal	Total
Petitioner	$ 511,755.22	$ 26,956,013.29	$ 27,467,768.51
Trusts for:			
Anne Harkness Mooney	127,938.80	2,006,139.62	2,134,078.42
Edith Hale Harkness	127,938.81	2,006,139.62	2,134,078.43
Allen West Pierce	127,938.81	2,006,139.63	2,134,078.44
Anne Terry Pierce	127,938.81	2,006,139.62	2,134,078.43
	$ 1,023,510.45	$ 34,980,571.78	$ 36,004,082.23

This characterization was attributable to the provision of the will that income earned during the period of administration of the estate was to be distributed proportionately to the interests in corpus. Hence, when the federal and state death taxes were paid out of the four trusts' share of corpus, a balancing distribution of corpus was made to the petitioner to keep the corpus interests of the petitioner and of the four trusts in equal balance, generating equal amounts of income (Pet. App. 26).

The $27,467,768.51 which petitioner received in 1955 from the residuary estate was 76.2907 percent of the total amount of $36,004,082.23 distributed to all beneficiaries during such taxable year (Pet. App. 24).

The distributable net income of the estate (less tax-exempt income) for 1955 of $826,758.68 was taken on the estate's income tax return for 1955 as a deduction for distributions to estate beneficiaries (Pet. App. 23). Petitioner included in her income tax return for 1955 one-half of the estate deduction, or $413,379.04 (Pet. App. 21, 65). Upon audit of her return, the Service applied Section 662(a)(2) of the Internal Revenue Code of 1954 (26 U.S.C. 662(a)(2)) which provides that where the amounts distributed to all beneficiaries of an estate accumulating income or distributing corpus exceed the distributable net income of the estate, each beneficiary shall include in his gross income an amount which bears the same ratio to distributable net income as the total amount distributed to him bears to the total of the amounts distributed to all the beneficiaries. Accordingly, the Internal Revenue Service determined that petitioner should have included in her gross income an amount equal to 76.2907 percent of the estate's distributable net income after exclusion of net tax-exempt income (Pet. App. 23-24). Petitioner's gross taxable income for 1955 was thereby increased to include both $413,379, her one-half share of net dividend and interest income for estate accounting purposes, and $217,361, representing a portion deemed corpus distributions for estate accounting purposes (Pet. App. 24, 65).

In her suit for refund of the resulting increased taxes, petitioner contended, *first*, that Section 662(a)(2) was not applicable to her case because the distributions of corpus were not made with intent to avoid taxes but

solely as a reasonable measure in the administration of the estate and, *second,* that any application of Section 662(a)(2) to her case would be unconstitutional since gifts of corpus of an estate are not income within the meaning of the Sixteenth Amendment.

The court below rejected the first contention, holding that Section 662(a)(2) covered all cases of estate or trust distributions of income and corpus (Pet. App. 27-32). It avoided any ruling on the constitutionality of the section on the ground that the estate and petitioner could have avoided the problem by not making any balancing distributions of corpus (Pet. App. 35-40). Petitioner here does not challenge the first ruling, but she renews her claim that the statute as applied is unconstitutional.

ARGUMENT

The decision below is correct, and there is no conflict or other reason for further review.

1. The basic policy underlying the income taxation of estates is that an amount equal to the net income of the estate should be taxed only once—either to the estate, or to a taxable beneficiary, or in part to each. To that end, Section 661(a) of the Code allows an estate a deduction for the sum of (1) any income "required to be distributed currently" and (2) "any other amounts properly paid or credited or required to be distributed" for the taxable year, provided the deduction does not exceed "distributable net income," *i.e.,* the taxable income of the estate determined with certain modifications not pertinent here. See 26 U.S.C. 643. In turn, Section 662(a) provides that distributions of income or corpus deducted by the estate are includible in the gross income of each beneficiary on a pro rata basis. Section 102(b) provides that the exclusion from gross income of

property acquired by devise or inheritance shall not extend to amounts included in gross income under Section 662(a).

This system of taxing estate and trust income was enacted, as the court below noted (Pet. App. 28-31), to resolve a problem under prior law created by the unqualified exclusion of bequests and gifts of corpus from gross income. Prior to the 1954 Code revision it was necessary to trace the source of estate and trust distributions in order to determine whether, under the provisions of the governing instrument and applicable trust and estate accounting principles, the distributions were made from current income or from corpus. The requirement of tracing was administratively unsatisfactory and resulted in complicated schemes of tax avoidance based upon trust or estate accounting designations of "income" and "principal."

As a remedy, Congress replaced the requirement of tracing with a relatively simple formula, which did not require reference to accounting distinctions between corpus and income. The concept of distributable net income was developed as the "measuring rod or yardstick" to determine the extent to which beneficiaries would be taxable on the distributions they received. *Manufacturers Hanover Trust Co.* v. *United States*, 312 F. 2d 785, 793 (Ct. Cl.), certiorari denied, 375 U.S. 880.

Thus Section 662(a) results in the taxation of distributions without regard to whether those distributions would be characterized as income or corpus for trust or estate accounting purposes.[1] Petitioner claims this

[1] For example, the Senate Finance Committee stated that "an annuity which is required to be paid at all events but which is payable only out of corpus is treated as an 'other amount * * * required to be distributed,'" *i.e.*, as an amount subject to tax as income. S. Rep. No. 1622, 83d Cong., 2d Sess. 348, 350.

result is unconstitutional. In other words, she would raise the old requirement of tracing to a new constitutional status. The crux of her contention is that the phrase "incomes, from whatever source derived," as used in the Sixteenth Amendment, is confined to the receipt of dividend or interest income from corpus, and does not embrace the receipt of the stocks and bonds comprising corpus. She relies primarily upon *Eisner* v. *Macomber*, 252 U.S. 189.

But this Court, in *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, and *James* v. *United States*, 366 U.S. 213, held that the definition of gross income in those earlier cases was not intended to fix the outer limit of that phrase. It gave the term "incomes, from whatever source derived" its broadest possible scope, as inclusive of any "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion" (*Glenshaw Glass, supra*, 348 U.S. at 431). Any receipt of money or other property that results in a net addition to the taxpayer's wealth, whether earned or unearned or out of another's capital, is realized income and constitutionally taxable as such.

Gifts and bequests of property are excluded from gross income, by Section 102(a), merely by legislative grace, not constitutional mandate. Section 102(b) and 662(a)(2) are in part exceptions from that exclusion; their operation in this case was to tax petitioner on her receipt of $217,361 of the $26,956,013.29 deemed corpus for estate accounting purposes. The entire receipt of corpus was constitutionally taxable as income. Only a small portion of it was in fact so taxed.

2. Even assuming, *arguendo*, that the receipt of a bequest is not income within the meaning of the Sixteenth Amendment, petitioner's constitutional challenge never-

theless fails. The only relevant limitation on the taxing power is the Article I requirement of apportionment; but that limitation affects only direct taxes and the tax in question is an indirect tax. A direct tax is a tax on real or personal property, imposed solely by reason of ownership. A tax on the income from such property, such as a tax on rents or interest, has also been considered a direct tax, since its incidence is the same as a recurring ownership. *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U.S. 429, on rehearing, 158 U.S. 601; *Simmons* v. *United States*, 308 F. 2d 160 (C.A. 4). Examples of direct taxes are state and local *ad valorem* taxes on real and personal property.

The tax in question is upon the receipt of property and not upon its ownership; taxes upon receipts, not having the same incidence as recurring taxes on ownership, are indirect taxes. *Scholey* v. *Rew*, 23 Wall. 331; *Knowlton* v. *Moore*, 178 U.S. 41; *Simmons* v. *United States, supra.* Cf. *New York Trust Co.* v. *Eisner*, 256 U.S. 345; *Fernandez* v. *Wiener*, 326 U.S. 340; *Bromley* v. *McCaughn*, 280 U.S. 124.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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